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Cases, Regulations and Statutes

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CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

DISCHARGE. The debtor leased a farm and improved the farm to accommodate a dairy operation. The debtor installed milking equipment and made improvements to the main barn. The debtor had granted a security interest in the milking equipment to another creditor. The debtor experienced problems with drainage in the farmhouse basement and the chicken coop became unusable during the lease period because of roof deterioration. The debtor and landlord had disputes about the operation of the farm and the landlord evicted the debtor on short notice. The debtor removed the milking equipment and left piles of manure on the property which the debtor claimed could not be removed before the required eviction date. The landlord filed a claim in the bankruptcy case for unpaid rent, cleanup costs and damage to the farm. The landlord sought to have the claims declared nondischargeable for malicious injury under Section 523(a)(6). The court found that the landlord failed to dispute the security interest in the milking equipment, prove that the drainage problem was caused by the debtor, prove the amount of unpaid rent, and refute the debtor's claim that no time was allowed to remove the manure. The landlord also did not provide any evidence of the cleanup costs. The court held that the landlord did prove that the debtor had intentionally or knowingly injured the landlord but that, at most, the damages were caused in the normal operation of the dairy or through the hurried eviction. ***In re* Feist, 225 B.R. 450 (Bankr. D. N.D. 1998)**.

PREFERENTIAL TRANSFERS. The debtor had entered into a contract for the custom feeding of cattle owned by a third party. The debtor borrowed money from a bank under a revolving loan agreement and granted the bank a security interest in inventory. The debtor made several cattle purchases without paying for the cattle, quickly sold the cattle and deposited the proceeds in the bank account. The debtor allowed the bank to withdraw the account funds to pay on the outstanding loan amount, although the debtor and bank knew that checks for cattle purchases were also outstanding. The bankruptcy trustee sought return of the account funds as preferential transfers and the third party sought recovery of the proceeds as subject to the custom feeding contract. The court held that the trustee could recover the account funds because (1) the transfer improved the bank's position, (2) the transfer was not made in the ordinary course of business and (3) the transfer was made within 90 days of the bankruptcy petition. The court also held that the bank's security interest did not attach to the cattle or proceeds because, under the custom feeding contract, title remained with the third party. ***In re* Haase, 224 B.R. 673 (Bankr. C.D. Ill. 1998)**.

FEDERAL TAXATION-*ALM* § 13.03[7].*

DISCHARGE. Three years after the debtor received a discharge in Chapter 7, the IRS sought to collect taxes for 1980-1983. The IRS argued that the taxes were not discharged because no income tax returns were filed for those years. The debtor's tax records for those years were seized by the IRS as part of a criminal investigation and were not returned to the debtor. The IRS argued that the debtor had the burden to prove the existence and filing of the returns. The Bankruptcy Court had acknowledged that an issue of fact existed as to the filing of the returns but granted summary judgment to the debtor on equitable estoppel grounds, holding that the debtor had the right to rely on the bankruptcy discharge, relieving the debtor of the responsibility to retain copies of the returns, especially because the IRS seized the returns and did not return them. ***In re* McKenzie, 225 B.R. 377 (N.D. Ohio 1998)**.

SALE OF CLAIM AGAINST ESTATE. The taxpayer's former spouse had filed for bankruptcy, causing all community property to become part of the estate, including oil and gas rights. The taxpayer filed a claim against the estate for the taxpayer's share of community property, but before the estate was distributed, the taxpayer sold the claim to a third party which asserted the claim in the bankruptcy case. The court held that I.R.C. § 1398(f) did not apply because the taxpayer did not receive any distribution from the estate but sold the claim outside of bankruptcy. Because the taxpayer had no income tax basis in the bankruptcy claim, the sale proceeds were taxable income. **Martin v. United States, 98-2 U.S. Tax Cas. (CCH) ¶ 50,889 (5th Cir. 1998)**.

FEDERAL AGRICULTURAL PROGRAMS

CROP INSURANCE. The FCIC has adopted as final regulations which amend the cotton crop insurance provisions and the extra long staple cotton crop insurance provisions for the 1999 and succeeding crop years to provide a replant payment if the insured crop is damaged by excess moisture, hail, or blowing sand or soil and is replanted; to revise the quality adjustment formula used to calculate the amount of production to count for cotton and ELS cotton; and to provide a prevented planting coverage level of 50 percent of the insured's production guarantee for timely planted acreage. **63 Fed. Reg. 66715 (Dec. 3, 1998)**.

The FCIC has adopted as final regulations which amend the common crop insurance policy basic provisions to add definitions and provisions to allow enterprise and whole farm units, allow the use of a written agreement to insure acreage that has not been planted and harvested in one of the three previous crop years, and amend the prevented planting provision that requires that at least one contiguous block of prevented planting acreage must constitute at least 20 acres or 20 percent of the insurable crop acreage in the unit before a prevented planting payment may be made. **63 Fed. Reg. 66706 (Dec. 3, 1998)**.

PEANUTS. The FSA has announced a proposed national peanut poundage quota figure in the range between 1,175,000 and 1,225,000 short tons. **63 Fed. Reg. 65133 (Nov. 25, 1998)**.

FEDERAL ESTATE AND GIFT TAX

SPECIAL USE VALUATION. The decedent's estate had elected special use valuation on farmland which reduced the value of the land for federal estate tax purposes from $988,000 to $349,770. Later, the qualified heirs sold a "conservation servitude" to New Jersey for $1,433,493.72 with a deed of easement which imposed restrictions on the property. The deed granted the conservation servitude by way of an "agricultural deed restriction for farmland preservation purposes" to the county under the New Jersey Right-to-Farm Act. The servitude specified that the land was to be maintained as a farm in perpetuity. The qualified heirs argued that the acquisition of the conservation servitude was only a contractual restriction on future use of the farmland and not a disqualifying disposition of an "interest" in the land subject to the special use valuation election. The IRS took the position that the granting of the conservation servitude triggered recapture because an interest in the real property was conveyed. The District Court, in ruling for the estate, observed that New Jersey law construed land use restrictions as "equitable servitudes," not property interests. Thus, the interest conveyed was only a contract right and not the disposition of an interest in the real estate. The appellate court reversed, holding that the transfer of the development easement was a disposition of an interest which caused recapture of special use valuation benefits. See Harl, "Transferring Development Rights: Special Use Valuation Recapture Event?" p. 57 *supra*. **Estate of Gibbs v. United States, 98-2 U.S. Tax Cas. (CCH) ¶ 60,333 (3d Cir. 1998),** ***rev'g*****, 98-1 U.S. Tax Cas. (CCH) ¶ 60,307 (D. N.J. 1997)**.

TRUSTS. The IRS has adopted as final regulations amending I.R.C. §§ 664 and 2702, concerning charitable remainder trusts. The amendments contain rules on the conditions under which the governing instrument may provide for a change in the method of calculating the unitrust amount, the date by which the annuity amount or the unitrust amount under the fixed percentage method must be paid to the recipient, who is required to value unmarketable assets, and when I.R.C. § 2702 applies to certain charitable remainder unitrusts. The regulations clarify existing law that prohibits allocating precontribution capital gains to trust income. The amendments also contain an example illustrating how the ordering rule of I.R.C. § 664(b) applies to distributions from a charitable remainder unitrust using an income exception method to calculate the unitrust amount. **63 Fed. Reg. 68188 (Dec. 10, 1998)**.

FEDERAL INCOME TAXATION

ACCOUNTING METHOD. The IRS has issued procedures to allow a taxpayer to automatically change the method of accounting under I.R.C. § 446 for deferred payment sales contracts relating to property used or produced in the trade or business of farming to the installment method for alternative minimum tax purposes. This change will allow a taxpayer to comply with Section 403 of the Taxpayer Relief Act of 1997, Pub. L. No. of 105-34, 111 Stat. 788 (1997), which repealed I.R.C. § 56(a)(6), relating to the AMT adjustment for installment sales, effective generally for dispositions in taxable years beginning after December 31, 1986.

A change to the installment method of accounting under I.R.C. § 453 for DPS contracts for AMT purposes is made on a cut-off basis either prospectively, beginning with the current taxable year (generally, the 1998 taxable year), or retroactively, beginning with an earlier taxable year by filing amended returns. No Form 3115 is required to be filed. To make the change in method of accounting prospectively, the installment method is used to report income from DPS contracts entered into in the current taxable year and all subsequent taxable years for AMT purposes if such method is used for the contract for regular tax purposes. No AMT adjustment should be made for these contracts related to the use of the installment method. Any amount of income from a DPS contract entered into prior to the year of change (i.e. prior to the current taxable year) that was reported in a prior taxable year for AMT purposes, must be reflected as a negative AMT adjustment in the taxable year that amount of income is reported for regular tax purposes. Taxpayers who made a prospective change in method of accounting for DPS contracts in 1997 are deemed to have complied with the requirements of these procedures.

To make the change in method of accounting retroactively, amended returns must be filed for any earlier taxable year that the taxpayer selects after which there is no closed taxable year and all affected subsequent taxable years for which a return has been filed. An entity (including a limited liability company) treated as a partnership or an S corporation for federal income tax purposes ("passthrough entity") may not file an amended return for any taxable year ending prior to the beginning of the earliest open taxable year of its partners, members, or shareholders after which there is no closed taxable year. The installment method must be used to report income from DPS contracts entered into in the year of change (i.e. the earliest taxable year for which an amended return is filed), and for all subsequent taxable years for AMT purposes if such method is used for the contract for regular tax purposes. The installment method may not be used to report income from DPS contracts entered into prior to the year of change for AMT purposes. Any amount of income from a DPS contract entered into prior to the year of change that was reported in a prior taxable year for AMT purposes, must be reflected as a negative AMT adjustment in the taxable year that amount of income is reported for regular tax purposes. Additionally, the minimum tax credit, if any, reported on Form 8801, for the amended return years must be recalculated. Passthrough entities must reflect all adjustments on the Schedule K-1 issued to partners, members, or shareholders.

Taxpayers within the scope of this revenue procedure that comply with these procedures have the consent of the Commissioner to change to the installment method of accounting under I.R.C. § 453 for DPS contracts for AMT purposes. **Rev. Proc. 98-58, I.R.B. 1998-__, __**.

The IRS has issued procedures by which a taxpayer may obtain automatic consent to change the method of accounting. This revenue procedure clarifies, modifies, amplifies, and supersedes Rev. Proc. 97-37, 1997-2 C.B. 455. Significant changes to Rev. Proc. 97-37 include: (1) the year of change is included within the five-year prohibition regarding prior changes; (2) the automatic extension of 6 months from the due date of the return provided in Treas. Reg. § 301.9100-2 is applicable; (3) the District Director is to ascertain if a change in method of accounting was made in compliance with all the applicable provisions of this revenue procedure; (4) an application reviewed and changed by the national office is subject to review by the District Director; (5) the effective date of this revenue procedure is December 21, 1998, for applications or copies of applications filed with the national office; (6) this revenue procedure is the exclusive procedure for making that change, includes property for which excess depreciation was claimed, excludes property for which depreciation is determined under Treas. Reg. § 1.167(a)-11, and requires additional information for any public utility property; (7) the change does not apply to a taxpayer that wants to change to the capitalization method for costs of developing (or modifying) any package design that has an ascertainable useful life; (8) a taxpayer is not required to file a Form 3115 to re-elect the LIFO inventory method after a period of five taxable years beginning with the year of change; and (9) a taxpayer wanting to make an IPIC change where a bulk bargain purchase previously occurred must first comply with *Hamilton Industries, Inc. v. Commissioner*, 97 T.C. 120 (1991), and compute an I.R.C. § 481(a) adjustment for the bargain purchase part of the change. **Rev. Proc. 98-60, I.R.B. 1998-__, __**.

COURT AWARDS AND SETTLEMENTS. The taxpayers filed suit for personal injuries to their daughter against the physician who assisted the birth of the daughter. The trial court jury awarded damages to the taxpayers and statutory prejudgment interest was added to the award. While the case was on appeal, the parties settled for an amount less than the total award but more than the jury award, with no part of the settlement allocated to prejudgment interest. The taxpayers excluded the entire settlement from gross income, but the IRS used the ratio of prejudgment interest to jury award to allocate to interest the same percentage of the settlement. The court upheld the IRS allocation formula. **Woods v. Comm'r, T.C. Memo. 1998-435**.

The taxpayer filed suit for personal injuries from a traffic accident. The taxpayer filed suit against the employer of the driver of the other vehicle. The trial court jury awarded damages to the taxpayer and statutory prejudgment interest was added to the award. While the case was on appeal, the parties settled for an amount less than the total award but more than the jury award, with no part of the settlement allocated to prejudgment interest. The taxpayer excluded the entire settlement from gross income, but the IRS used the ratio of prejudgment interest to jury award to allocate to interest the same percentage of the settlement. The court upheld the IRS allocation formula. **Perry v. Comm'r, T.C. Memo. 1998-433**.

IRA. The IRS has issued revenue procedures for (1) obtaining opinion letters to drafters of Roth IRAs and (2) transitional relief for users of Roth IRAs that have not been approved by the IRS. **Rev. Proc. 98-59, I.R.B. 1998-__, __**.

INTEREST RATE. The IRS has announced that, for the period January 1, 1999 through March 31, 1999, the interest rate paid on tax overpayments is 7 percent and for underpayments is 8 percent. The interest rate for underpayments by large corporations is 10 percent. **Rev. Rul. 98-61, I.R.B. 1998-__, __**.

JOINT LIABILITY. The IRS has announced interim guidance to taxpayers seeking equitable relief under I.R.C. § 6015(f) in three areas: (1) threshold conditions that must be satisfied in order for an individual to be considered for relief under I.R.C. § 6015(f); (2) the circumstances in which relief under I.R.C. § 6015(f) will ordinarily be granted in the situation where an individual did not know, and had no reason to know, that funds intended for the payment of tax were instead taken by the spouse for the spouse's benefit; and (3) for all other requests for relief under I.R.C. § 6015(f) and all requests for relief under I.R.C. § 66(c), a partial list of factors to be considered in determining whether it would be inequitable to hold an individual liable for a deficiency or unpaid liability. **Notice 98-61, I.R.B. 1998-__, __**.

LEVY. The IRS has issued Publication 1494, providing tables which show the amount of an individual's income that is exempt from a notice of levy used to collect delinquent tax in 1999. **Notice 98-60, I.R.B. 1998-__, __**.

LOAN TO QUALIFYING CARE FACILITY. The IRS has announced the inflation-adjusted amount that a taxpayer 65 years old or older may lend to a qualifying care facility without incurring imputed interest as allowed under I.R.C. § 7872(g)(2). For 1999 the amount is $137,000. **Rev. Rul. 98-59, I.R.B. 1998-__, __**.

QUALIFIED DEBT INSTRUMENTS. The IRS has announced the 1999 inflation adjusted amounts of debt instruments which qualify for the 9 percent discount rate limitation under I.R.C. §§ 483 and 1274:

Year of Sale or Exchange	1274A(b) Amount	1274A(c)(2)(A) Amount
1999	$3,885,500	$2,775,400

The $3,885,500 figure is the dividing line for 1999 below which (in terms of seller financing) the minimum interest rate is the lesser of 9 percent or the Applicable Federal Rate. Where the amount of seller financing exceeds the $3,885,500 figure, the imputed rate is 100 percent of the AFR except in cases of sale-leaseback transactions, where the imputed rate is 110 percent of AFR. If the amount of seller financing is $2,775,400 or less (for 1999), both parties may elect to account for the interest under the cash method of accounting. **Rev. Rul. 98-58, I.R.B. 1998-_, __**.

RETURNS. The IRS has announced it's intention to develop a system of providing alternative identifying numbers for preparers, as authorized by Section 3710 of the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685. Individual preparers are reminded of their continuing responsibility to furnish their social security numbers ("SSNs") on returns or claims for refund prepared by them. **Notice 98-63, I.R.B. 1998-__, __**.

S CORPORATIONS-*ALM* § 7.02[3][c].*

RE-ELECTION. An S corporation elected to terminate its S corporation election. More than 50 percent of the corporation's stock was transferred to three shareholders who were not shareholders when the termination election was made. The shareholder sought to re-elect S corporation status within five years after the termination election. The IRS granted the re-election because more than 50 percent of the stock was held by shareholders who were not shareholders when the termination election was made. **Ltr. Rul. 9848014, Aug. 26, 1998**.

SOCIAL SECURITY TAX. The IRS has filed an appeal in *Wuebker v. Comm'r, 110 T.C. No 31 (1998)* (information supplied by Paul Wright, attorney for the taxpayers). See Harl, "SE Tax on CRP Payments," p. 100 *supra*.

WAGES. An employee received an erroneous payment of wages in one year and repaid the erroneous wages in a subsequent year. The IRS position is: (1) Repayments of salary received in a prior year do not reduce the amount of wages paid to the employee for FICA and federal income tax withholding purposes in the year of the repayment. Thus, any remuneration for employment in the year of repayment which was used to repay the erroneous salary was not excludable from wages for FICA and federal income tax withholding purposes. Also, the repayment of salary did not reduce gross income for the prior year or affect the amount of income tax withheld in the prior year. (2) To the extent additional FICA taxes (including social security and Medicare taxes) were paid in the prior year because of the erroneous salary payment, the repayment of the salary in a subsequent year created an overpayment of FICA taxes in the prior year, and credit could be claimed by the employer with respect to its FICA tax liability for that prior year subject to the statute of limitations. (3) Pursuant to section 31.6051-1(c) of the Employment Tax Regulations and subject to the statute of limitations, to the extent repayments of erroneous salary made by an employee resulted in a reduced amount of social security wages and/or Medicare wages for the prior year and reduced amounts of employee social security taxes and/or Medicare taxes paid for the prior year, the employer is required to furnish corrected Forms W-2 for that prior year showing the employee's corrected "Social security wages (if applicable)," corrected "Social security tax withheld (if applicable)," corrected "Medicare wages and tips," and corrected "Medicare tax withheld." No changes should be made in the entries for "Wages, tips, other compensation" (Box 1 of Form W-2) or for "Federal income tax withheld" (Box 2 of Form W-2). The repayment of salary received in a prior year has no effect on the Form W-2 for the year of the repayment. The employer should furnish the employee a separate receipt acknowledging the repayment for the employee's records. (4) If the employee received wages in the first year under a claim of right and included the wages in gross income for the first year, and then subsequently repaid the wages to the employer in a later year and was entitled to a deduction, then the employee may be entitled to an alternative method of calculating the amount of tax for the later year under I.R.C. § 1341. However, the employee would only be entitled to the alternative method of calculation in Section 1341 if the amount of the overpayment was greater than $3,000. **SCA 1998-026, (Aug. 13, 1998)**.

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**Agricultural Law Manual* (ALM)..